

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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JUN 30 2005

PUBLIC SERVICE
COMMISSION

In the Matter of the:

APPLICATION OF THE UNION LIGHT,)
HEAT AND POWER COMPANY TO)
IMPLEMENT A HEDGING PROGRAM)
TO MITIGATE PRICE VOLATILITY IN)
THE PROCUREMENT OF NATURAL GAS)

CASE NO. 2005-00191

COMMENTS OF THE ATTORNEY GENERAL

Comes the Attorney General, through his Office for Rate Intervention, pursuant to the procedural schedule established by Order dated June 1, 2005, and files his written comments concerning the Petition of Union Light, Heat and Power to continue its summer and winter hedging plans. The only changes to the plans are the request to extend the term of the plan by a year, the request to gain a grant of authority to hedge further out into the future, and the request to set a certain mandatory minimum for the hedging activity.

The Attorney General is no more persuaded that hedging is efficacious for ratepayers than he has been in other years. He continues to object to any hedging plan on the grounds that all costs are assigned to the rate payer and on the grounds that the approval of a hedging plan is substituted by the Company for use of its judgment to pursue the best blend of gas supply purchasing practices available under the conditions existing at the time purchasing decisions are made. Regardless, given that the Commission has expressed a strong and continuing preference for hedging in the volatile market, comments will address the plan as presented.

In the opening paragraph of the introduction to the Natural Gas hedging plan, ULH&P says,

“...the hedging strategy increased costs when natural gas prices were low and decreased costs when natural gas prices were high. Since the hedging plans have achieved their goal of reducing volatility in purchased gas costs, hedging natural gas prices should become a standard part of ULH&P’s gas supply portfolio.”
Plan, p. 1.

This statement, in combination with the request to lengthen the period over which purchases may be made under the hedging plan, returns the company ever nearer to the purchasing practice of the era in which companies engaged predominately in long-term gas supply purchases, a practice that made for less volatile pricing but also meant customers were not able to realize the advantages of least cost purchasing. Given the continuation of a volatile and ever higher priced market, the issue now is how the interest in least cost pricing should be balanced against the interest in smoother pricing gained through relatively long-term purchases/purchases in which the price is set well ahead of purchase in order to establish the smoothest and most cost effective gas supply. Working further into the future assumes that there will be no respite in either the volatility or upward trend of the market. If that is true, more distant forward hedging makes sense.

However, if the balance is again swinging toward longer-term purchases in order to secure relatively smoother costing, then the question becomes whether the purchasing practice should be reviewed as the old prudence reviews were conducted, which seemed to have been done after the fact, or whether the prudence of purchasing practices should be assumed from approval of parameters set before the purchase contracts are made.

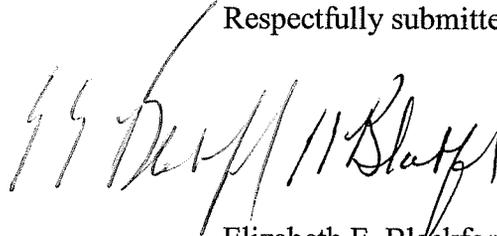
When longer-term purchases and purchases in which the price was set well ahead were the norm before the move to short-term least-cost purchasing practices gained approval, it appears from review of the orders of the Commission that the pricing and terms of the supply purchases were reviewed after the contracts were made, giving the Commission the ability to

determine the prudence of each purchase as made, with the full terms of the purchase before them for review. As this hedging proposal would work, rather than reviewing the prudence of the purchases as actually made, parameters would be set and prudence would be assumed for purchases falling within those parameters. The Attorney General is concerned about the diminishment of regulatory oversight inherent in adding this step of removal from the prior prudence reviews afforded longer term purchases. Direct regulatory oversight consisting of review of the contract itself when made is preferable to the more distant regulatory oversight that occurs when standards within which a contract will be presumed to be prudent are established up to three years before the contract is made, but the contract itself and the circumstances in which it is made are not subject to direct regulatory oversight.

The Attorney General is also concerned about the renewed request to establish a minimum amount to be hedged. In response to staff data request 2 asking it to identify the advantages of a mechanistic hedging feature, ULH&P stated that establishing a minimum to be hedged “will assure an adequate level of hedging in an uncertain market” to cover unforeseen circumstances. The Attorney General continues to object to any mechanistic approach to hedging. The Company should be obligated, as well as free, to pursue the most prudent gas purchasing strategy for any given time period. The approved hedging plan should not encourage or permit the Company to constrain itself to implementing pre-approved purchasing practices that are unresponsive to the needs of the season its purchases will cover. To the extent that the establishment of a lower range of volumes to be hedged operates to constrain the exercise of prudent purchasing practice, no lower range should be set. If the Commission approves a hedging plan in which the Company is permitted to implement a mechanistic plan in lieu of using its expertise to engage in the most prudent purchasing plan dictated by the market itself,

the Commission is assigning all costs of gas purchasing to rate payers, not just the cost of prudent purchases, and is shifting all risk from the Company. If the program is approved, it should not have a volumetric minimum hedging requirement.

Respectfully submitted



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NOTICE OF FILING AND CERTIFICATE OF SERVICE

Notice is hereby given that the original and ten true copies of the foregoing have been filed with the Executive Director of the Kentucky Public Service Commission by hand delivery to 211 Sower Boulevard, Frankfort, Kentucky 40601, this the 30th day of June, 2005. I further certify that this same day the parties have been served by mailing a true copy, postage prepaid, to Counsel of Record as follows:

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